INTRODUCTION

To begin the Three-Tier Review process, interviews were conducted with more than 100 stakeholder participants. The issues stakeholders raised were grouped into three categories that correspond to the three primary strategies used by the Washington State Liquor Control Board for management and enforcement of alcohol control responsibilities. This paper addresses Category 3 – Control and Enforcement.

The areas of potential change for this category, identified in stakeholder interviews and prioritized by the Task Force:

- <u>LCB in competition with other beer and wine retailers (high priority)</u>
- Lack of LCB enforcement resources (high priority)
- Lack of impact measures (high priority)
- Criteria for regulations (high priority)
- <u>Rules for LCB in retailing (high priority)</u>
- Priority of enforcement resources (medium priority)
- Complexity of regulations (low priority)
- Abundance of paperwork (low priority)

This paper focuses on 1) whether the LCB has an unfair pricing advantage in the sale of wine and 2) on whether the LCB should be subject to the same constraints of other wine retailers.

Executive Summary: LCB Retailing of Wine and Beer

Issue Statement:
Some retailers believe the LCB has an unfair pricing advantage because it is not required to follow the same set of regulations for wine and beer sales as private retailers.

- Does the LCB sell wine and beer at an unfair price advantage in state stores?
- Should the regulations pertaining to wine sales for the LCB be changed?

- The LCB has been a wine retailer since its creation in 1934.
- In 1969, changes in the law allowed wine to be sold through private retailers. Since then, the number of private retail outlets where wine is sold has increased significantly.
- Retailers are concerned the LCB has an unfair pricing advantage in the sale of wine and beer.
  - Many retailers attribute this advantage to the fact the LCB is not subject to the same regulatory constraints as private retailers.
  - The LCB is subject to other constraints, however, which limit the LCB's ability to compete in wine market.
- In 2005, in response to concerns raised by the private retailers, the LCB increased its mark-up on wine to more closely reflect average private sector retail prices. As a result, wine sales have declined in state stores but recovery of market share is expected**.**
- The LCB currently holds a 7.1% market share in the sale of wine, down from 8.2% in FY 2005. The LCB has determined it will limit its market share to 10% or less.
- The LCB reports the state receives over $11 million in annual net revenues from the sale of wine and beer in state and contract liquor stores.
- The current system is thought to have a generally positive impact on consumers and the state, and has both a negative and positive impact on private business. The impact on society is largely neutral.

Options for LCB in competition for wine and beer sales:

1. <u>Continue the current price strategy of maintaining a 43% markup and keep the LCB market share below 10%.</u> (This represents "no change" from the existing pricing policy that was put in place in October 2005) (no impact, but continued frustration of private retailers)
2. <u>Require the LCB to sell no lower than the minimum price allowed of other retailers</u> (+ solves competition and policy strategy inequity issues, could provide additional revenue to the state, but – does not address the fact that the LCB still has other advantages associated with fewer constraints)
3. <u>Rescind the LCB's authority to sell beer and wine in state stores</u> (+ eliminates competition for private retailers, - reduces state sales revenue, reduces customer convenience, eliminates a primary distribution channel for some small wineries)

Reference for current law/rule/practice: RCW 66.

I. Brief Issue Statement and Corresponding Question

Some retailers believe the LCB has an unfair pricing advantage because it is not required to follow the same set of regulations for wine and beer sales as private retailers.

- Does the LCB sell wine and beer at an unfair price advantage in state stores?
- Should the regulations relating to the LCB retail operations for wine and beer sales be changed?

II. Description of Current Environment

The LCB is the exclusive retailer of spirits in Washington State. However, sales of lower-alcohol content wine and beer are licensed to a wide variety of retail. The state stores also carry wine and beer products.[1]

The LCB has been a wine retailer since its creation at the end of prohibition.

- Originally, the state was the only channel for the sale of out-of-state wine. Wines produced in Washington, however, could be sold in grocery stores and other retail outlets.
- In 1969 the law was changed to allow out-of-state wine to be sold in grocery stores and other private venues.
- Currently, 60% of the wine sold in Washington is sold in chain grocery stores. About 20% is sold in big-box stores. The remaining 20% is sold in beer and wine shops, neighborhood markets, convenience stores and state and contract liquor stores.
- According to the LCB, wine sales account for $38 million of the $650 million in gross sales achieved by state and contract liquor stores annually. It is difficult to estimate the percentage of revenue returned to the state based on wine sales in state and contract stores. However, somewhat more than $11 million of the $263 million returned annually to the state from the LCB can be attributed to wine sales.

The number of retail outlets where wine is sold has increased significantly.

- In 1969 there were 273 LCB retail stores.
- Today, there are 161 state stores, 154 contract liquor stores and the LCB licenses 4,814 off-premise retail outlets including grocery stores, convenience stores and specialty wine shops.

[1] This section draws heavily from the LCB's *Wine Program Strategy 2004-2009* and Dave Pavelchek's 2003 report, *A comparison of Wine Prices: State Liquor Stores and Major Grocery Chains.*

At least five recent studies have addressed the topic of whether, and under what circumstances, the state should be selling beer and wine. *See Appendix B.* These studies have generally concluded the state has an appropriate role in the sale of wine and beer, or at a minimum have not recommended the state stop the sale of wine and beer. According to the LCB, the state remains in the wine business for the following reasons:

- Wine sales provide added convenience and customer service;
- Wine sales produce additional revenue for the state; and
- State stores have historically sold wine, and they provide an important marketing venue for small Washington wineries.

The LCB has determined it will limit its market share to 10% or less.

In 2005, the LCB increased its mark-up on wine to more closely reflect average private sector retail prices. In 2004, the LCB conducted a pricing survey, comparing the prices of its 100 top-selling wines to average prices of the same wines sold in retail outlets. The survey indicated that the state's prices were lower for 89 of the 100 wines. In an effort to achieve greater price parity with the private sector, in October of 2005 the LCB raised the mark-up on all wines sold in state stores from 38% to 43%. (This followed a short-term price change that raised the prices of the 89 wines that were being sold at below-average retail prices.) *Appendix C describes the LCB's approach to wine pricing.*

Wine sales have declined in state stores but recovery of market share is expected.

Since the increased mark-up was implemented:

- The LCB's market share (of liters sold) dropped to 7.1% from 8.2% in FY 2005; and
- LCB wine sales dropped more than $2 million (a nearly 6% decline) between July 2005 and May 2006.

The LCB reports wine sales are stabilizing, and ultimately the board anticipates recovering to a market share near the agency's established 10% market share limit. *(See Board Wine Pricing and Market Share Issue Paper, July 12, 2006.)*

III. <u>Issues raised by industry stakeholders</u>

During Focus Group interviews, many retailers expressed concern that the LCB has an unfair pricing advantage in the sale of wine and beer.

- Private retailers are subject to a variety of regulatory constraints, designed to further the state's goals of preventing the misuse of alcohol, promoting the efficient collection of taxes and providing for the orderly distribution of alcohol.
  - Key constraints identified by interview participants include: requirement to purchase wine at posted prices, prohibition on quantity purchase discounts, prohibition on central warehousing, prohibition against purchasing product on credit from distributor, and a mandatory minimum markup on purchases.

- Private retailers largely agree the regulatory constraints do result in higher prices to the consumer, because they increase the retailer's business costs, which then must be passed along to the consumer.
- Retailers are concerned that the LCB can sell wine and beer at an unfair price advantage because it operates is state and contract stores under a different set of constraints than those in effect for private retailers.
  - Constraints on Private Wine Sellers:
    - Must procure product from licensed supplier or distributors.
    - Product is subject to a 10% minimum markup.
    - Cannot receive quantity discounts on products.
    - May not purchase product on credit.
    - Price posting and one-month holds on prices limit flexibility.
    - May not operate a central warehouse facility.
  - Constraints on State Stores:
    - State is prohibited from advertising outside its stores.
    - Store hours are limited.
    - By internal policy, state wine prices are set for a three-month period.
    - The state may not sell non-alcoholic products in its stores.
- In addition, retailers see the state's ability to offer lower prices as inconsistent with the state's stated rationale of maintaining higher prices as a means of reducing abusive consumption.
- Many retailer focus group participants felt the state should either have to "play by the same rules" as their private sector counterparts, or it should get out of the business of selling wine and beer altogether.
- **Not all private sector participants in the wine industry are unhappy with the LCB as a wine retailer.** According to some wine producers, the LCB provides a crucial outlet for their product.

Note: Although the state liquor stores are also allowed by law to sell beer, the issue has been of much lesser concern because the quantity and selection carried by state stores is negligible. The following discussion, therefore, is directed only to wine sales.

IV. Contribution to State's Policy Goals

1. Does LCB's involvement in the retail sale of beer and wine contribute to the state's policy goal of preventing the misuse of alcohol? If yes, how?

No. If the state were the only retailer of beer and wine, the argument might be made that the state is preventing misuse by limiting access to beer and wine. But private retailers are licensed to sell beer and wine so the state's involvement can rather be seen as increasing access to these products. And, since the state's prices are often on the low end, and at times lower than, private retail prices the state is not preventing misuse of alcohol through higher prices.

2. **Does LCB's involvement in the retail sale of beer and wine contribute to the state's policy goal of efficient collection of taxes? If yes, how?**

   It neither hinders nor contributes to this policy goal.

3. **Does this regulation promote the state's policy goal of fostering the orderly and responsible distribution of malt beverages and wine towards effective control of consumption? If yes, how?**

   It neither hinders nor contributes to this policy goal.

V. Current System Impact Assessment

NOTE: This impact assessment is based on feedback received from industry participants and a review of relevant documents and literature. It is not intended to provide an exhaustive assessment of all potential impacts. The impacts identified have not been thoroughly tested or evaluated.

CONSUMER (price, convenience, selection)	**BUSINESS** (costs, unnecessary market restrictions, revenues, private employment)	**STATE** (state resources, state sales and tax revenues, state employment)	**SOCIETY** (alcohol misuse, youth access to alcohol, environmental pressures encouraging misuse)
• **Potential for lower prices** • **Convenience of one-stop shopping** • **Increased selection**	• **Some retailers may be losing business** • **Some producers may be getting product placement that would otherwise be unavailable**	• **Increased revenues** • **Ability to better serve customers** • **Supports development of the state's wine industry**	• **Potential for small increase in access because of lower prices and more outlets**

See Appendix D for a detailed discussion of the Current System Impacts Assessment.

VI. Policy Options

***NOTE**: These options are offered to stimulate discussion. **They are not necessarily the best or only alternatives available**. The analysis of potential benefits and drawbacks represents our best efforts at assessing impacts based on feedback received from industry members, and a brief review of relevant literature. They have not been thoroughly tested or evaluated.*

	Consumers	**Business**	**State**	**Society**
Option 1	**NC**	**NC**	**NC**	**NC**
Option 2	**--**	**+/--**	**+**	**NC**
Option 3	**+**	**+**	**+**	**--**

Option 1: Continue the current price strategy of maintaining a 43% markup and keep the LCB market share below 10%. (This represents "no change" from the existing pricing policy that was put in place in October 2005.)

Potential benefits: No impact to state revenues, consumer purchasing patterns or options, and no impact on LCB employment.

Potential drawbacks: Private retailers may continue to be frustrated over the perceived inequities in the current regulatory structure.

Option 2: Require the LCB to sell no lower than the minimum price allowed of other retailers.

This option would likely result in the following changes:

Potential benefits: Higher wine prices in state liquor stores may result in reduced purchasing and therefore, presumably, consumption. The state receives more sales revenue if prices are raised. Private retailers are satisfied that the state does not have a competitive advantage.

Potential drawbacks: This option would likely result in higher prices for wine at state liquor stores for consumers. Wine retail sales may decrease, with a potential decrease in state sales revenue.

Option 3: Rescind the LCB's authority to sell beer and wine in state stores.

Potential benefits: Private retail sales would increase. Sales overall may be slightly reduced because customers purchasing both wine and spirits would need to make two separate trips. Instead, they may choose to either substitute one for the other (double their purchase of wine and forego spirits, or vice versa), or they may simply decide not to make the second purchase in which case overall purchases (and thus consumption) would be reduced.

Potential drawbacks:

- State revenues would be reduced.
- Consumer convenience would be reduced.
- Wine producers may lose revenue due to decreased sales if consumers do not replace their state store wine purchases with private retail purchases. (Some consumers may substitute additional spirits purchases.)
- Some in-state smaller wine producers may lose revenues or go out of business because they are unable to market their product effectively in private sector stores.

APPENDICES

A – Background

B – Recent Studies Addressing the State's Role in Retail Wine Sales

C – LCB Wine Pricing Practice

D – Current System Impact Assessment

APPENDIX A
Background

The Washington State Liquor Control Board (LCB) was established in 1933 to control the flow of alcohol in Washington State through licensing and enforcement of alcohol-related regulations and by managing state liquor stores. (RCW Chapter 66). The LCB is also responsible for monitoring and collecting Washington State alcohol license fees and sales tax revenue.

The LCB directly manages 161 state liquor stores and contracts for management of 154 stores selling spirits, beer and wine. In 2005, the LCB licensed and monitored 12,331 retail licensees including: 4,814 retail outlets that sell alcohol for off-premise consumption, 7,274 restaurants, taverns, and sports/entertainment facilities for on-premise alcohol consumption, and 243 bed & breakfast and other retail licensees. The LCB also licensed and monitored 1,690 non-retail licensees: 183 distributors and importers, 353 in-state wineries, 84 in-state breweries, 960 out-of-state wineries and breweries, and 110 other licensees (bonded wine warehouses, liquor manufacturers, wine growers, CCI and ship handlers).

Through licensing and a comprehensive set of regulations, the LCB is responsible for enforcing the applicable laws, rules and policies that support the state's goals to prevent the misuse of alcohol, efficiently collect taxes and provide for orderly distribution of alcohol.

The LCB carries out its enforcement duties through three divisions, Enforcement and Education (85 Liquor Enforcement Agents) Licensing and Regulation (*** FTEs), and Manufacturers, Importers and Wholesale (MIW) (*** FTEs).

In addition to its control and enforcement roles, the LCB manages and contracts with 315 state liquor stores, providing sales revenue to the state, along with the tax revenue from all alcohol sales.

Licensing and enforcement were not part of the scope of the three-tier study. However, there were a number of issues for potential change identified by interview participants that fall into this category. The Task Force rated several of these items as the highest priority for change.

APPENDIX B
Recent Studies Addressing the State's Role in Retail Wine Sales

- In 1983, the Office of Financial Management explored the issue of whether the state should be in the business of retail liquor sales.[2] In that study, the more specific issue of whether the state should be selling wine and strong beer at the retail level was considered. The OFM study included in its appendix a review by the Legislative Budget Committee (LBC, now the Joint Legislative Audit and Review Committee). The financial analysis conducted at that time led the LCB study team to conclude that the state should continue.
- In 1995, prompted by declining sales of wine in state stores, the Board conducted a review of the state's wine program. The board considered the option of eliminating wine from its retail inventory, but instead determined that improvements should be made to the program. As a result of this study, the LCB hired a wine program manager, and began the development of a wine retail strategy.
- The issue of whether the state should be in the business of selling wine in its retail stores came up again in 2000 as part of a study conducted by the Washington State Retail Liquor Sales Task Force. The final report states that, although no clear consensus on recommendations was reached by the Task Force members, they did agree there was a need to address "fair practices" in this area.

Two additional pricing studies were completed in the last few years.

- In December 2003, a Washington State University study concluded that when considering regular and sale prices, the LCB's prices are significantly toward the low end of the price distribution, while not significantly lower than the lowest grocery store prices. However, when "member club" prices are included in the analysis, LCB prices are competitive, but within the range of prices offered by retail grocers.
- In 2004, a study was conducted of the top selling 100 wines, comparing LCB prices with the average retail prices. The LCB was selling 89 of the 100 wines under the average retail price by an average of 13%. As a result, the LCB raised its markup from 38% to 43% to more closely reflect average retail prices.

Fiscal Year	Wine Sales	LCB Liters	Market Share	% Markup
2001	$36,802,779.00	6,236,266	9.6%	38
2002	$38,039,620.00	6,449,392	9.8%	38
2003	$39,045,711.00	6,612,116	9.0%	38
2004	$38,144,333.00	6,464,827	8.3%	38
2005	$38,891,883.00	6,505,885	8.2%	38 / 43

** Top 100 in effect, 1/2005-6/2005*
Source: Steve Burnell, LCB Wine Program Manager

[2] *The Desirability of Continuing Retail Liquor Sales by State Government,* Office of Financial Management, July 1983, pp. 61-31, pp. 151-165.

APPENDIX C

LCB Wine Pricing Practice

The LCB can purchase wines either directly from a supplier (such as a wine manufacturer) or through a wholesaler. The supplier or wholesaler is not required to sell to the LCB at their posted price. They can offer their product at any price they determine is appropriate.

LCB Wine Pricing Formula
Illustrating a typical 750 ML bottle of wine

Supplier / Wholesaler price to LCB	$	10.00
Outbound Freight	$	1.44
Subtotal	$	11.44
43% Markup	$	4.92
Subtotal	$	16.36
Wine Liter Tax ($0.2292 per liter)	$	0.17
Per-Case Surcharge	$	1.80
TOTAL	**$**	**18.33**

The LCB sets prices on wine products through a "mark up" formula. This methodology begins with a base price quoted from the producer or wholesaler (federal taxes are included in the base price), and a freight charge is added on. The state's markup (currently 43%) is then applied. To that, the state wine liter tax of $0.2292 per liter ($0.4536 for wines with an alcohol content over 14% -- typically fortified wines) and a per-case surcharge of $1.80 are added. The result is the final retail price. The state liquor stores change their wine prices every three months. This practice reduces the administrative expenses of price changes (labor involved in swapping out shelf labels, and price list printing costs, for example.)

When a supplier offers the LCB product at a sale price, the LCB may offer that product to consumers at a "temporary price reduction" (TPR). Like all wine prices, the LCB only changes its TPRs every three months.

APPENDIX D

Current System Impact Assessment

NOTE: This impact assessment is based on feedback received from industry participants and a review of relevant documents and literature. It is not intended to provide an exhaustive assessment of all potential impacts. The impacts identified have not been thoroughly tested or evaluated.

A. Impacts on Consumers
(price, convenience, selection) **Positive**

- State liquor store prices may be lower than private retailers.
- Making wine available at state liquor stores is a convenience for customers who chose to purchase wine and spirits in one location.
- The LCB asserts its emphasis on Washington wines provides an outlet for some wines that otherwise may not be competitive if only offered through a wholesaler, and provides general support for the Washington wine industry. As a result consumers may benefit by a broader array of wines.

B. Impacts on Business **Negative** **Positive**
(costs, unnecessary market restrictions, revenues, private employment)

- Private wine retailers believe they are losing sales to the state liquor stores because the regulatory structure under which the state stores operate provides a significant pricing advantage.
- Some smaller, in-state wine producers might have a difficult time finding a market for their product, and difficulty in distributing their product. The LCB's support of Washington wine industry has likely provided some support to these entities.

C. Impacts on the State **Positive**
(state resources, state sales and tax revenues, state employment)

- The state receives increased revenue from the sale of wine and beer in state liquor stores. (In addition to tax revenues, the state also collects the markup.)
- Some smaller, in-state wine producers may have a difficult time finding a market for their product, and difficulty in distributing their product. The LCB's support of Washington wine industry has likely provided some support to these entities. In addition, the LCB annual in-store promotions highlight Washington wines.

D. Impacts on Society **Neutral**

(alcohol misuse, youth access to alcohol, environmental pressures encouraging misuse)

- Lower prices in state liquor stores may stimulate slightly higher purchasing rates, than if sold at a higher price. However, it is difficult to know whether the discouraged purchaser simply purchased the same product elsewhere.
- Added convenience of being able to purchase both wine and spirits in one location may contribute to slightly higher rates of purchase in cases where a consumer had not intended to purchase both spirits and wine but was stimulated by the availability of the product at the liquor store.